MAD
Intelligent
Systems

# CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM

3,000,000 Shares of Convertible Preferred Stock

MAD Intelligent Systems Inc.

This Private Placement Memorandum (the "Memorandum") relates to the sale of up to 3,000,000 shares of Series C Preferred Stock of MAD Intelligent Systems Inc. (the "Company") at $3.30 per share. The Company currently has 4,757,333 shares of Series C Preferred Stock outstanding. See "History of Financing." Prior to this offering there has been no market for the Common or Preferred Stock of the Company, and no such market is expected to develop following this offering. References herein to the "Shares" shall include all shares of Series C Preferred Stock.

THESE SECURITIES ARE SPECULATIVE AND INVOLVE A HIGH DEGREE OF RISK. THE COMPANY HAS NO SIGNIFICANT OPERATING HISTORY.

THE SHARES OFFERED HEREBY HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933. AS AMENDED (THE "ACT") OR UNDER ANY STATE SECURITIES LAW, NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE REGULATORY AUTHORITY PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PRIVATE PLACEMENT MEMORANDUM OR ENDORSED THE MERITS OF THIS OFFERING. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The Shares are offered pursuant to exemptions provided by the Act and certain state securities laws, and certain rules and regulations promulgated pursuant thereto. The Shares may not be transferred in the absence of an effective registration statement under the Act or under applicable State Securities Laws or an opinion of counsel that an exemption from registration is available.

The Company is offering the shares of Series C Preferred Stock to certain qualifying shareholders of the Company and to other investors who qualify as "accredited investors" under Regulation D of the Act ("Accredited Investors") and to investors who are neither residents nor citizens of the United States of America.

The Company reserves the right in its discretion to waive the suitability standards and to increase or decrease the number of Shares sold, provided, however, that no more than 5,000,000 Series C Shares shall be offered or sold.

| | Price to Investor | Proceeds to the Company(1) |
|---|---|---|
| Per Share..... | $3.30 | $3.13 |
| Total..... | $9,900,000 | $9,400,000 |

(1) After deducting sales commissions and offering expenses estimated at $500,000.

May 1, 1986

THE SHARES BEING OFFERED HEREBY (THE "SHARES") HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT"), OR UNDER ANY STATE OR FOREIGN SECURITIES LAWS, NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE OR FOREIGN REGULATORY AUTHORITY PASSED UPON THE ACCURACY OR ADEQUACY OF THIS MEMORANDUM OR ENDORSED THE MERITS OF THIS OFFERING. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE. THE SHARES ARE OFFERED PURSUANT TO THE EXEMPTIONS PROVIDED BY THE ACT AND CERTAIN STATE AND FOREIGN SECURITIES LAWS, AND CERTAIN RULES AND REGULATIONS PROMULGATED PURSUANT THERETO.

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THE SHARES HAVE NOT BEEN QUALIFIED WITH THE COMMISSIONER OF CORPORATIONS OF THE STATE OF CALIFORNIA, AND IN THE ABSENCE OF QUALIFICATION OR AN EXEMPTION THEREFROM, THE ISSUANCE OF THE SECURITIES OR THE PAYMENT OR RECEIPT OF ANY PART OF THE CONSIDERATION THEREFORE IS UNLAWFUL. THE RIGHT OF ALL PARTIES TO THE SERIES D PREFERRED STOCK PURCHASE AGREEMENT ARE EXPRESSLY CONDITIONED UPON SUCH QUALIFICATION BEING OBTAINED OR AN EXEMPTION BEING APPLICABLE.

IT IS THE RESPONSIBILITY OF ANY PERSON WISHING TO PURCHASE THE SECURITIES TO SATISFY HIMSELF AS TO FULL OBSERVANCE OF THE LAWS OF ANY SUCH PURCHASE, INCLUDING OBTAINING ANY REQUIRED GOVERNMENTAL OR OTHER CONSENTS OR OBSERVING ANY OTHER APPLICABLE FORMALITIES.

THE BUSINESS — MACHINES BOB-B.

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## SUMMARY OF THE OFFERING

The following summary information is qualified in its entirety by the detailed information and financial data and notes thereto appearing elsewhere in this Memorandum.

### The Company

MAD Intelligent Systems, Inc. ("MAD" or the "Company") was founded in 1982 and to date has primarily developed, manufactured and marketed IBM-compatible microcomputer systems based on the Intel 80186 and 80286 processors. In the past 18 months, however, the Company has commenced development of advanced intelligent systems that integrate state-of-the-art computer hardware with high performance software, based on artificial intelligence ("AI") and combining the techniques of management science and decision analysis ("DA"). Such intelligent systems are targeted to professionals in vertical markets, and are designed to enable those users to formulate and solve problems, then communicate the solutions.

These expert systems will help users solve problems where data may be uncertain, incomplete, or inconsistent, and where judgment and expertise are required for high quality decision making. These systems will include hardware which is sufficiently powerful to execute artificial intelligence software, and which is cost effective. These intelligent systems will meet the need for a cost effective solution to the information and knowledge processing needs of professionals in specialized industry segments, or "vertical markets." Deliveries of the intelligent systems product line are projected for 1987.

The Company has pursued a strategy of marketing its 80186 and 80286-based products to original equipment manufacturers ("OEM") who integrate them into their product lines. Currently, the Company's major OEM contract is a multi-year, multi-million dollar OEM contract with Philips International N.V. See "Special Investment Considerations--Agreements with Philips International, N.V. and Philips Information Systems, Ltd."; "Strategic Alliances--Philips International N.V.".

Additionally, the Company is in various stages of negotiation with several other American and European computer manufacturers.

The Company believes that the future of business computing will demand AI and DA software customized to the needs of vertical business markets. Accordingly, the Company recently adopted a significant reorganization plan to focus more of its resources on AI and DA development and less on sales of 80286-based conventional products to OEMs. The Company plans to market its intelligent systems product line to OEMs serving the financial services vertical market first. Products addressing needs in the transportation and communications markets will follow.

MAD Intelligent Systems, Inc. was incorporated in February, 1982 under the name of MAD Computer, Inc. To more accurately communicate the AI and DA development focus of the Company, the Company changed its name to MAD Intelligent Systems, Inc. in May of 1985. A wholly owned subsidiary, MAD Intelligent Systems GmbH, headquartered in Munich, West Germany, was incorporated in October, 1983 as a sales office to serve the European OEM markets. The Company is a California corporation with executive offices at 2950 Zanker Road, San Jose, California 95134. Telephone No. (408) 943-1711.

## The Offering

The Company is offering 3,000,000 shares of its Series C Preferred Stock at $3.30 per share to qualified U.S. investors and investors in Europe and other foreign countries. The Company currently has 4,757,333 shares of Series C Preferred Stock outstanding. See "History of Financing."

The Series C Preferred Stock offered hereby will be entitled to dividends at the rate of $0.20 per share per annum when and if declared by the Board of Directors. The Series C Preferred Stock will carry a liquidation preference of $2.00 per share and will be convertible one-to-one into Common Stock, subject to adjustments for certain diluting issues of additional equity securities. The Series C Preferred Stock will convert automatically upon a public offering and will be redeemable after November 1, 1987. Holders of the Series C Preferred Stock offered hereby, together with holders of the outstanding Series A and B Preferred Stock, will be entitled to two demand registrations in certain circumstances and unlimited piggyback registration rights subject to certain limitations. Certificates representing the shares of Series C Preferred Stock will bear legends restricting their transfer under federal and state securities laws.

## Use Of Proceeds

The net proceeds to the Company from the sale of 3,000,000 shares of Series C Preferred Stock, based on an estimate of all expenses and fees associated with this offering and assuming all shares of Series C Preferred Stock are sold, are estimated to be approximately up to $9,400,000. The Company has significant short term cash needs, however, and the Company's failure to receive in the near term the proceeds of a substantial amount of such $9,400,000 could have a material adverse effect on the Company's business and financial condition. See "Special Investment Considerations--Current Cash Needs and Future Financing Requirements." The Company intends to use the proceeds to provide funds for working capital and general corporate purposes, including product development, manufacturing build up, product sales expenses and financing of increases in inventories and accounts receivable. The Company also intends to use part of the proceeds of any sales of Series C Preferred to liquidate, at reduced rates, its obligations to its vendors. See "Litigation-Other"; "Special Investment Considerations--Litigation."

Until expended, the net proceeds will be invested in interest-bearing, low-risk obligations. The Company reserves the right to change the use of proceeds of the offering, as set forth herein, as a result of changes in its business plan or operations or as a result of future developments.

Management estimates that the net proceeds of this offering, if all shares are sold, will satisfy the Company's working capital requirements for the period from May 1986 through December 1987. See "Special Investment Considerations -- Current Cash Needs and Future Financing Requirements."

**SELECTED FINANCIAL INFORMATION**

SUMMARY STATEMENT OF OPERATIONS, CONSOLIDATED
($-000's)

| | Actual, Audited | | Unaudited | Unaudited Quarter Ended |
|---|---|---|---|---|
| | Year ended 12/31/83 | Year ended 12/31/84 | Year ended 12/29/85 | March 28, 1986(2) |
| REVENUE | $ 212 | $ 9,380 | $ 5,159 | $ 1,100 |
| COST | -- | 8,735 | 8,247 | 1,625 |
| GROSS MARGIN | 212 | 645 | (3,088) | 475 |
| EXPENSES | 2,874 | 6,040 | 7,666 | 1,325 |
| LOSS | $ (2,776) | $ (5,395) | $ (10,754)(1) | $ (1,800) |

SUMMARY BALANCE SHEET, CONSOLIDATED
(-$000's)

| | Actual, Audited | | Unaudited | Unaudited Quarter Ended |
|---|---|---|---|---|
| | Year ended 12/31/83 | Year ended 12/31/84 | Year ended 12/29/85 | March 28, 1986(2) |
| Assets: | | | | |
| Current | $ 2,765 | $ 5,777 | $ 1,055 | $ 800 |
| Other | 343 | 1,005 | 1,353 | 1,200 |
| Total Assets | $ 3,108 | $ 6,782 | $ 2,408 | 2,000 |
| Liabilities: | | | | |
| Current | 717 | 7,518 | 3,908 | 4,700 |
| Other | 1,000 | 613 | 300 | 300 |
| Total Liabilities | $ 1,717 | $ 8,131 | 4,208 | 5,000 |
| Shareholders' Equity | 1,391 | (1,349) | (1,800) | (3,000) |
| Total Liabilities & Shareholders' Equity | $ 3,108 | $ 6,782 | $ 2,408 | 2,000 |

(1) The loss of $10.8 million for the 1985 fiscal year is attributable to the following factors:
- (a) Write off of all assets associated with the Company's 186 product line, including inventory, tooling, test equipment, etc. - $3.5m;
- (b) Factory underutilization prior to volume production of the 286 product line - $1.2m;
- (c) Engineering development costs of 286 product line - $1.8m;
- (d) Manufacturing expenses associated with the commencement of volume 286 production - $.6m;
- (e) Hardware development expense for 386 product line - $.3m;
- (f) Expert systems planning and development costs - $.6m.

(2) Does not reflect the sale of the Company's 80286-based technology to Philips Information Systems, Ltd.

## DIVIDENDS

The Company has paid no cash dividends since its inception, and has no present plans to pay dividends in the foreseeable future. It is the present policy of the Board of Directors to retain all earnings to provide for the growth of the Company.

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## HISTORY OF FINANCING

In conjunction with the founding of the Company in 1982, Dr. Nafeh transferred to the Company technology owned by him and valued at $1,075,000 in exchange for 6,000,000 shares of common stock of the Company.

In December, 1983, the Company sold and issued 2,053,200 of its Series A Preferred Stock at a price of $1.35 per share with aggregate proceeds of $2,592,270.

Also in 1983, the Company received $500,000 in cash in consideration for warrants issued to Telex Computer Products, Inc. These warrants were exchanged during 1985 for 1,000,000 shares of the Company's common stock.

In May, 1984, the Company sold and issued 783,484 shares of its Series B Preferred Stock at a price of $3.75 per share with aggregate proceeds of $2,655,913. By amendment of the Articles of Incorporation in connection with the Series C offering, the conversion rights of the Series B stock were revised to conform to the conversion rights of the Series C stock, which are based on an initial conversion price of $2.00 per share.

On June 17, 1985 the Company sold and issued 2,129,000 shares of its Series C Preferred Stock at a price of $2.00 per share with aggregate proceeds of approximately $3,760,200.

As of April 15, 1986 subscriptions and full payment for 2,628,333 additional shares of Series C Preferred Stock, at a price per share of $3.00, had been received by the Company.

On March 31, 1986 Telex Computer Products, Inc. ("Telex") purchased 558,333 shares of Series C Preferred Stock at $3.00 per share in consideration of cancellation of $1.675 million in debt. Telex was the guarantor of such debt, with the principal obligee thereon being Enterprise Finance Corporation ("Enterprise"). See "Strategic Alliances -- Telex Computer Products, Inc."

As of the date of this Memorandum, the total number of shares of the Company's Common Stock and Preferred Stock outstanding is 15,197,033.(1)

If all 3,000,000 shares offered by this Memorandum are sold, the total number of shares outstanding after the sale of all such shares will be 18,197,033.(1)

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(1) Includes shares of the Company's common stock issuable upon conversion of shares of Series B Preferred Stock in accordance with the conversion provision of the Company's Restated Articles of Incorporation.

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## BUSINESS

### The Company

MAD Intelligent Systems, Inc. ("MAD" or the "Company") was founded in 1982 and to date has developed, manufactured and marketed IBM-compatible microcomputer systems based on the Intel 80186 and 80286 processors. In the past 18 months, the Company has commenced development of advanced intelligent systems that integrate state-of-the-art computer hardware with high performance software, based on artificial intelligence ("AI") and combining the techniques of management science and decision analysis ("DA"). Such intelligent systems are targeted to professionals in vertical markets, and are designed to enable those users to formulate and solve problems, then communicate the solutions.

These expert systems will help users solve problems where data may be uncertain, incomplete, or inconsistent, and where judgment and expertise are required for high quality decision making. These systems will include hardware which is sufficiently powerful to execute artificial intelligence software, and which is cost effective. These intelligent systems will meet the need for a cost effective solution to the information and knowledge processing needs of professionals in specialized industry segments, or "vertical markets." Deliveries of the intelligent systems product line are projected for 1987.

The Company has pursued a strategy of marketing its 80186 and 80286-based products to original equipment manufacturers ("OEM") who integrate them into their product lines. Currently, the Company's major OEM contract is a multi-year, multi-million dollar OEM contract with Philips International N.V. See "Special Investment Considerations--Agreements with Philips International N.V. and Philips Information Systems, Ltd."; "Strategic Alliances--Philips International N.V.".

Additionally, the Company is in various stages of negotiation with several other American and European computer manufacturers.

The Company believes that the future of business computing will demand AI and DA software customized to the needs of vertical business markets. Accordingly, the Company recently adopted a significant reorganization plan to focus more of its resources on AI and DA development and marketing and less on sales of 80286-based products to OEMs. The Company plans to market its intelligent systems product

line to OEMs serving the financial services vertical market first. Products addressing needs in the transportation and communications markets will follow.

MAD Intelligent Systems, Inc. was incorporated in February, 1982 under the name of MAD Computer, Inc. To more accurately communicate the AI and DA development focus of the Company, the Company changed its name to MAD Intelligent Systems, Inc. in May of 1985. A wholly owned subsidiary, MAD Intelligent Systems GmbH, headquartered in Munich, West Germany, was incorporated in October, 1983 as a sales office to serve the European OEM markets. The Company is a California corporation with executive offices at 2950 Zanker Road, San Jose, California 95134. Telephone No. (408) 943-1711.

## Products

### Introduction

Current methods offered by MAD to satisfy business computer needs consist of 80286-based workstations, either used alone, connected to each other, or connected to mainframe computers and minicomputers. MAD has implemented these methods by developing and marketing the MAD-1 and D1000 workstations. The Company has integrated these workstations with networks and communications facilities.

Future products will incorporate knowledge based products based on artificial intelligence. They will provide intelligent user interfaces that rely heavily on graphics. Accordingly, MAD is developing its intelligent systems which coordinate advanced computer hardware, artificial intelligence, decision analysis and management sciences.

In addition to satisfying the computational needs of users, the Company's AI products will protect users' investments in existing software, hardware and databases. This will be achieved in two complementary ways. On the one hand, high level languages for describing data files and computational libraries will be developed as part of MAD's intelligent systems. On the other hand, MAD's products will use (but will not be limited to) standard operating systems, peripheral interfaces, and communications and graphics protocols.

The workstations and intelligent systems may be combined with products provided by manufacturers other than MAD. The performance and compatibility of the Company's integrated product spectrum with industry standards will make it a highly flexible and expandable system.

## Workstations, Networks and Communications

MAD currently offers a workstation product line, based on the use of modern 16-bit microprocessor technology.

The D1000 workstation, designed around the Intel 80286 processor, was introduced in April of 1985. This product line is aimed at applications requiring more computational power or higher resolution graphics capabilities. The powerful Intel 80287 floating point coprocessor is offered as an option with the D1000. Graphics features are being offered through a proprietary development effort. In keeping with the Company's overall approach, a major emphasis of this product line is its compatibility with existing standards for 80286 based microcomputers.

Business computing requires strong communications capabilities so that workstations and other computers may be connected. In addition, business computing requires the sharing of expensive system resources such as mass storage and fast printers. MAD has addressed these needs by incorporating the use of local area networks and mainframe gateways.

## Intelligent Systems

The high end of MAD's product line will be intelligent systems that integrate the technologies of advanced computer hardware, together with the techniques of artificial intelligence, decision analysis, and management sciences.

The hardware will be designed around the Intel Corporation 32-bit processor (80386), and floating point coprocessors. The powerful numeric processing capabilities of these processors will be augmented by a symbolic processing environment. These systems will rival the power of today's minicomputers. In addition, upward compatibility with the rest of MAD's product families, and with industry standards, will be retained.

Each intelligent system will consist of a Knowledge Server, with gateways to mainframes, and to which several workstations and file servers can be connected.

The Knowledge Server will consist of a Knowledge Base and an Inference Engine, which jointly provide powerful problem solving tools.

The Knowledge Base will contain Heuristic Knowledge, Procedural Theory Knowledge, and Factual Data Base Knowledge. The reasoning

within the Inference Engine will be oriented towards problem formulation and solution in response to user requests. The Inference Engine will be significantly domain independent.

The new MAD workstation will be one of the first available to incorporate new technology capable of delivering expert systems and IBM compatibility.

This delivery environment will mimic the development environment for expert systems, such as the Symbolics, Inc. computer, with high resolution graphics, windowing capabilities, and symbolic processing capability. In addition, this new workstation will be one of the few available to incorporate IBM compatibility, together with the power to deliver expert systems software.

Existing workstations are not only less powerful, but have been pieced together. Professionals and managers have had to acquire hardware and software from different vendors, which have not been optimized to the user. The MAD workstations will provide custom designed hardware and software to deliver all the information and knowledge processing power a professional needs, in a cost effective manner.

MAD will develop these systems for three vertical markets, in this sequence:

- financial industries
- transportation
- communications

This powerful new hardware will be differentiated from competitors by several levels of special software, which are optimized to the application, culminating in special purpose applications software, namely, expert systems targeted at specific groups of users.

Expert systems are computer programs that have emerged from the field of artificial intelligence. The goal of these systems is to get computers to solve problems the way experts do, and to disseminate expertise from the few who have it to the many who need it. Some well-known expert systems provide human users with expert conclusions about such specialized subject areas as diagnosing disease, evaluating potential ore deposits and providing advice about how to configure computer systems.

Expert systems are not locked into any specific decision path but can pick from alternative paths in searching for a conclusion. They can weigh facts and assumptions and make choices appropriate for each problem presented to them. Furthermore, an expert system can display, on request, its line of reasoning in human language

form. A user can ask the system how it knows something or why it is giving a certain recommendation, and will get an accurate answer, justified in terms that make sense to a human user.

The expert systems software will be characterized by the following distinguishing features:

- The combining of artificial intelligence with decision analysis and the techniques of management science; and

- The ability to access conventional databases and on-line data sources, without requiring of the user that he know arcane syntax of various databases or different database management systems.

Strategic Alliances

MAD has developed the basic technology that will be used to integrate the Company's planned advanced hardware and software, in order to produce affordable microcomputer systems incorporating artificial intelligence. To take advantage of this work, the Company has formed strategic alliances with a leading firm for the manufacture and distribution of office equipment systems in the U.S. and Europe based on the Company's basic 80186 and 80286-based products and is currently engaged with Intel Corporation and Lucid Inc. in study of possible joint development projects based on the Intel 80386 processor. The Company believes that through these corporate relationships MAD can rapidly enter the broad business office market with its current products and rapidly address the needs of the financial services industry with its artificial intelligence based products currently under development.

**Philips International N.V.**

MAD entered into a three-year OEM relationship with Philips on October 21, 1985 for its 80286-based IBM AT compatible workstation (the "P3200"). At any given time, Philips is only required to place firm orders for product for four months in advance of the delivery date. Philips has no minimum order volume under such OEM agreement beyond such rolling four-month order period. Discussions are currently being held with Philips related to the development and manufacture of several additional products. Additionally, preliminary discussions are underway relating to financial expert systems for Philips.

On March 31, 1986, the Company sold all of its P3200 technology to a wholly-owned Canadian subsidiary of Philips, Philips Information Systems, Ltd. ("PIS") for $1.5 million. Concurrently, the Company

licensed all such technology back on a royalty-free basis. In connection with this sale and license back transaction, PIS agreed to finance certain inventory needs of the Company for manufacture of products under the above-referenced OEM Agreement with Philips. To secure this obligation, PIS took a security interest in all accounts receivable and inventories of the Company. The transaction documents contain a number of covenants by the Company. Breach of these covenants could give PIS the rights of a secured party with respect to the Company's accounts receivable and inventory. Moreover, there can be no assurances that Philips will continue to purchase product from MAD rather than PIS at the end of any four month firm order period. See "Special Investment Consideration--Agreements with Philips International N.V. and Philips Information Services, Ltd.".

The transaction documents give MAD the right to repurchase the technology for $1.5 million until July 1, 1988. If MAD exercises such right, PIS will be entitled to retain a manufacturing license covering such technology, with royalties for any unit produced by PIS that uses any MAD technology.

Telex Computer Products, Inc.

In connection with MAD's default on the promissory note evidencing the Enterprise indebtedness, and as a prerequisite to the agreement by Philips Information Systems, Ltd. to purchase certain technology from MAD and finance certain of the Company's inventory build ups Telex repaid such $1.675 million owed by MAD to Enterprise, assumed such debt itself, and agreed to convert such assumed debt into shares of Series C Preferred Stock. In connection with Telex's purchase of stock from the Company, John Nafeh, Chairman and CEO of the Company, transferred to Telex 1,116,667 shares of the Company's common stocked owned by him in exchange for certain rights of repurchase with respect to such 553,338 shares of Series C Preferred purchased by Telex from the Company in consideration of the cancellation of the Enterprise indebtedness. Dr. Nafeh retains certain rights of retransfer from Telex with respect to such shares of Common Stock.

The Company's main past customers have included Telex Computer Products, Inc., Triumph-Adler AG (a major European office equipment manufacturer) and S.M.T. Goupil (a large French distributor of computers and office equipment). The Company is currently receiving approximately $20,000 per month in royalty revenues from these customers.

## Marketing

While the Company is directing its primary focus on development and OEM marketing of AI products and expert systems, the Company intends to continue marketing its 80286-based products to OEMs. See "Special Investment Considerations--Dependence on Key Management Personnel".

### Marketing Strategy

MAD's marketing strategy is to serve the needs of its OEM customers by insuring that the Company understands the particular markets served by its OEM's, and to develop its products hand-in-hand with OEM customers. Currently, the Company's only OEM agreement that is projected to generate significant revenues in the near term is with Philips International, N.V. See "Special Investment Considerations--Agreements with Philips International N.V. and Philips Information Systems, Ltd."; "Strategic Alliances - Philips International, N.V." The Company, however, is in various stages of negotiation with other computer manufacturers, both in the U.S. and Europe. The Company believes that the IBM compatibility of the Company's current and proposed products, the development of artificial intelligence capabilities and most of all, the ability to meet MAD's customers' needs will differentiate MAD from its competitors in seeking to penetrate the OEM marketplace.

### Distribution

The Company has adopted a marketing strategy focussing on sales of its current products solely through OEMs. The Company's sales organization is divided into two sections, one in the United States and one in Europe.

MAD's OEM organization in the U.S. consists of a direct sales organization of account managers who call on target accounts in the U.S. and Canada.

In the long range, the Company's distribution strategy will focus on securing OEM alliances that can generate significant orders each year. The Company is currently focusing its marketing efforts on OEMs who provide distribution of its proposed AI products into the following markets:

- intelligent terminals
- financial services
- office automation
- transportation and distribution

The Company sells its products in Europe through MAD Intelligent Systems GmbH. This allows the Company to respond to the needs of the European market efficiently and effectively. Key personnel within the subsidiary provide the Company with a unique level of credibility for an American-based company in the European market.

**OEM Relationships**

The Company's marketing strategy is to have OEMs integrate the Company's products, generally under the OEM's label, into their own product line in order to expand their markets or replace their present products. OEMs generally provide application software for vertical markets, end-user applications support, field maintenance and financing alternatives.

The use of OEMs is projected to be strategically important to the Company for the following reasons:

- They are already well placed in the market segments within which the Company operates.
- They have their own promotion and sales programs which the Company can supplement.
- They are not in the head-to-head, heavy price cutting, highly volatile, retail personal computer marketplace.
- They need and are looking for high-end capability products to satisfy their customers' requirements.
- Their added value specifically mitigates the commodity-oriented price-sensitive conditions in the personal computer market.
- They do not require or benefit from the massive advertising and public relations campaigns needed in the retail personal computer market.
- They have a strong interest in long-term product lines with the following characteristics which the Company offers:
  - serving a wide range of specific vertical markets
  - decision-making power through application of artificial intelligence and decision analysis
  - networking
  - high compatibility with industry standard

## Competition

The Company's product is Intelligent Systems which integrate AI and DA software with hardware optimized for vertical business markets. The Company does have competitors who manufacture hardware and/or produce and market software. The Company, however, believes that there are few, if any, other computer manufacturers that are able to offer fully integrated computer systems similar to those currently being designed by the Company.

Hardware competitors include IBM and Convergent Technologies. Software competitors include Lotus Development Corp., Ashton-Tate, Microsoft and IBM. Competitors producing AI-oriented hardware include Symbolics Inc. and Xerox Corporation. Competitors producing financial expert systems include APEX, Syntelligence and Palladian. While Syntelligence is a direct competitor, Applied Expert Systems (APEX) and Palladian are not currently direct competitors because their products address the financial decisions of corporations but not primarily those of financial institutions. Neither of these products is aimed at providing expert systems to improve the decision making of financial institutions regarding how they manage themselves. The Company, therefore, believes that these competitors currently have different customers than does MAD.

There are other expert system companies that may be initially targeting different industries, but are a threat because they have the development strength. Examples are, Iconics, Expert Technologies, Carnegie Group.

The Company recognizes that a number of these competitors have greater financial resources than it has. The Company also expects that additional companies will enter the market associated with both non-artificial intelligence-based hardware and software and artificial intelligence-based hardware and software.

## Manufacturing

MAD currently produces products under its own name and under private labels for its OEM customers. The Company, however, plans to completely discontinue its own manufacturing capability by the end of September 1986. Thereafter, the Company plans to subcontract all of its manufacturing. Discussion with subcontract manufacturers are currently under way with companies in Japan and Canada.

Multiple sources are available for the majority of parts and components currently used by the Company in its manufacturing. Its Intel-designed microprocessors are available from multiple sources. Components used in its products are purchased from both distributors

and manufacturers. The Company purchases disk drives, monitors, and power supplies assembled in Japan, Taiwan and Hong Kong.

The Company intends to develop several custom integrated circuits for cost reduction purposes of its 80286 based circuits. It will own the exclusive design and manufacturing rights to these components.

Less than 5% of the Company's manufacturing costs is constituted by direct labor. The workforce consists primarily of semi-skilled assemblers and electronic technicians. Training is done in-house.

## Facilities

MAD occupies a 69,700 square foot building in San Jose, California. This building has been designed to the Company's specifications. The Company has a five year lease on the building with an option to extend the term for an additional five years. This building serves as the Company's corporate headquarters, production facility, and research and development center. The lease rental cost of the facility averaged $35,000 per month for the first twelve months and $35,000 per month during the following years, subject to cost of living adjustments every thirty (30) months.

## Employees

On April 21, 1986, the Company had approximately 63 employees of whom 9 were in sales and marketing, 10 in engineering and technology, 21 in manufacturing, and 15 in general and administrative operations. In addition, there were 6 employees in MAD's German subsidiary, 3 of them in sales and sales support, 3 of them in administration. The Company's ability to remain competitive depends, in part, upon its ability to attract and retain experienced people. The Company has a number of employee benefit programs designed to accomplish this goal, including an employee stock option plan, group medical, dental and life insurance plans, and vacation and sick leave programs. None of the Company's employees is represented by a labor union and the Company has had no work stoppages. As a result of the Company's reorganization and greater emphasis on development of AI products rather than 80286-based products, the Company is terminating employees that are redundant and not replacing certain employees who have left the Company voluntarily as a result of the reorganization. See "Special Investment considerations--Dependence on Key Management Employees"; "Retention and Recruitment of Other Key Personnel."

## Patents and Trademarks

The Company currently holds one patent for the monitor foot on its first generation product that is no longer in production. The Company believes, however, that the ownership of patents with respect to its products that currently are in production is less significant than technological expertise, management skills and product marketing strength. The Company does believe that patents may be important with respect future products that are currently in planning, and the Company intends to pursue patents with respect to such products.

## MANAGEMENT

Executive Officers and Directors

The executive officers and directors of the Company and their ages at April 21, 1986 are as follows:

| | | |
|---|---|---|
| John Nafeh | 43 | Chairman of the Board and CEO |
| Stephen J. DePaoli | 34 | Vice President, Manufacturing |
| Klaus O. Schmidt | 46 | Vice President and General Manager, MAD Intelligent Systems GmbH |
| Robert R. Blackmer | 45 | Vice President, Engineering |
| Richard F. Carlton | 41 | Vice President, Sales and Marketing |
| Sandra Cook | 43 | Vice President, Expert Systems |
| Ralph H. Dudley | 50 | Vice President, Quality |
| Ronald A. Howard | 49 | Director |
| John P. Zinn | 46 | Director |
| Erich Daume | 47 | Director |

DR. JOHN NAFEH, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER founded MAD Intelligent Systems, Inc. in February, 1982, and developed the first product of the MAD-1 family of advanced work-stations within one year. Earlier, Dr. Nafeh formed MultiMedia Video, Inc. (1977), and successfully marketed microcomputer systems and software internationally. Prior to that, he held high-level management positions at General Electric and Ford Aerospace. Dr. Nafeh has 15 years professional experience in business planning, economic risk analysis and priorities evaluation, as well as policy decision analysis.

Dr. Nafeh earned a B.S.E.E. degree in Alexandria, Egypt, and M.S. and Ph.D. degrees in engineering-economic systems at Stanford University. Dr. Nafeh is a member of Sigma XI, the Scientific Research Society of North America.

STEPHEN J. DEPAOLI, VICE PRESIDENT OF MANUFACTURING, is responsible for all of MAD's manufacturing operations. In a previous position as vice president of manufacturing operations for Televideo, he took product line shipments from start-up status to $60 million annually. He also had a dramatic influence on the growth of Cromemco, Inc. as director of manufacturing, and held a previous position at Hewlett-Packard as production engineering manager.

Mr. DePaoli earned an M.B.A. from the University of Santa Clara and a B.S. degree in electrical engineering and computer science from the University of California at Berkeley.

KLAUS O. SCHMIDT, GENERAL MANAGER AND VICE PRESIDENT OF EUROPEAN OPERATIONS, is managing MAD's OEM and distributor sales force in Europe. He is responsible for the Company's wholly-owned subsidiary, MAD Intelligent Systems GmbH, at its Munich, West-Germany, headquarters. Mr. Schmidt, a German national, previously served as general manager for Apple Computer's central European operation, and also worked with other high-technology companies in Europe, including Perkin-Elmer Data Systems, Advanced Controls, Interdata, and NCR.

Mr. Schmidt holds a degree in mechanical engineering and general business management.

ROBERT R. BLACKMER, VICE PRESIDENT OF ENGINEERING, was directly involved with the engineering and product development of the MAD-1 family of advanced workstations, and is responsible for all new hardware product development. Before joining MAD as Director of Development, he worked as a staff engineer for Onyx + IMI, Inc., with International Memories, Inc., a manufacturer of Winchester disk drives, at Zilog, Data Terminals and Communications, and General Electric.

Mr. Blackmer earned his M.S. and B.S. degrees in electrical engineering from San Jose State University.

RICHARD F. CARLTON, VICE PRESIDENT OF SALES AND MARKETING, is responsible for MAD's domestic sales activities and worldwide marketing. He has over eighteen years of sales and marketing experience in the

computer peripheral marketplace. Prior to joining MAD, he was Vice President of Sales for Iomega Corporation. Previously, he spent over thirteen years with Control Data Corporation in various management positions.

Mr. Carlton earned a B.A. in economics and marketing from St. Cloud University.

DR. SANDRA COOK, VICE PRESIDENT, EXPERT SYSTEMS, is responsible for leading MAD's efforts in defining and developing Artificial Intelligence based application packages. Dr. Cook joined MAD from SRI International where she was Manager of its Financial Expert Systems Program and Director of the Financial Technology Management Department. Dr. Cook's professional expertise encompasses applied AI, expert systems design and business problem solving for financial industries through application of advanced technology. At SRI, Dr. Cook developed several expert systems, including one to evaluate international bank loans.

Dr. Cook's academic credentials include a B.A. in philosophy, University of Kansas; an M.A. and Ph.D. in mathematical logic from Wayne State University, and a M.Sc. from the London School of Economics. Dr. Cook has held a faculty position with the Systems Research Group at the London School of Economics and Political Science, and is an occasional lecturer at Stanford University's Graduate School of Business.

DR. RALPH H. DUDLEY, VICE PRESIDENT, QUALITY, has a long and distinguished career in the areas of product quality control and reliability. Before joining MAD, Dr. Dudley was corporate director of product safety and quality assurance for Varian Associates. From 1973 to 1978 he held various important quality-related positions with Lockheed Missiles and Space Co.

Dr. Dudley has lectured extensively at colleges and universities, and holds five academic degrees: a Ph.D. in Engineering and an M.S. in Operations Research from USC; an MBA from Rollins College; an M.S. in Civil Engineering from Columbia University, and a Bachelor of Civil Engineering from Manhattan College.

DR. RONALD A. HOWARD, DIRECTOR, has been a professor at Stanford University since 1965 and is associated with the School of Engineering, Department of Engineering-Economic Systems. He helped define the discipline of decision analysis. In addition, Dr. Howard is a founder and chairman of the Board of Directors of Strategic Decisions

Group, a management consulting firm in Menlo Park, California. He has been a member of MAD's Board of Directors since January 1984.

JOHN P. ZINN, DIRECTOR, is a Vice-President in the Corporate Mergers and Acquisitions Department at Morgan Guaranty Trust Company of New York. Prior to that, he was the administrative head of the Mergers & Acquisitions Department at Blyth Eastman Paine Webber, Inc. He has been a member of MAD's Board of Directors since October, 1984.

ERICH DAUME, DIRECTOR, is the chairman and chief executive officer of various financing, trust and trading companies in Europe. He has held different management positions in banks in Switzerland and abroad. Mr. Daume, currently located in St. Gallen, Switzerland, has been a member of MAD's Board of Directors since August 1985.

JOSEPH J. MIKELONIS, C.P.A., formerly Vice President, Finance of the Company has resigned from that position, but has agreed to direct the Company's financial functions as a consultant for the next two to three months while the Company searches for a successor. Mr. Mikelonis was previously President of Adelphi Associates, Inc., a manufacturer of test equipment for the computer disk industry. He also held top financial positions at Momentum Computer Systems, Inc., Halcyon Communications, Inc., Comdat Inc., and held several finance and management positions at Memorex Corporation and Fairchild Camera and Instrument Corporation.

Mr. Mikelonis earned an MBA and a B.S. in accounting from Long Island University and performed public accounting with the firm of Price Waterhouse and Co.

Remuneration

In the twelve month period through December 29, 1985, Stephen J. DePaoli, Vice President, Manufacturing, received direct remuneration of $73,183; Klaus Schmidt, Vice President and General Manager of MAD Intelligent Systems GmbH, received $80,000; Robert Blackmer, Vice President of Engineering, received $69,948; and Sandra Cook, Vice President of Expert Systems, received $48,373. In addition,

$65,004 has been accrued for payment to Dr. John Nafeh who has not received any salary during this period.

Employee and Director Stock Incentives

In 1983, the Company adopted an Incentive Stock Option Plan (the "Plan") pursuant to which an aggregate of 700,000 shares of the Company's Common Stock are reserved for issuance upon the exercise of stock options granted or to be granted under the Plan. The Plan is administered by the Board of Directors. The exercise price with respect to each option granted under the Plan must be no lower than 100% of the fair market value of the Company's Common Stock on the date the option is granted. Unless otherwise provided by the Board, each option is exercisable in four annual installments commencing one year after the date of grant. All options contain normal antidilution provisions, terminate upon discharge for cause, and are immediately exercisable under certain circumstances. As of April 15, 1986, options to purchase 1,179,500 shares had been granted and were outstanding. The Company increased the number of shares available under the Plan to 1,200,000 on February 19, 1985. The Company's Board of Directors has authorized an additional 500,000 shares of common stock to be reserved for issuance to employees under the Plan.

The Company has reserved an aggregate of 2,000,000 shares of Common Stock (including stock to be issued pursuant to exercise of employee stock options under the Plan) to be sold and issued to employees or consultants to the Company. Where services are being provided over time, it is the Company's intention that any shares sold and issued to such individuals be subject for some period to the Company's right to purchase all or a portion of those shares at the price originally paid by the employee or consultant if that person leaves the Company's employ or ceases providing services to the Company. This right would gradually diminish over time (usually four years) so that at the end of that period, the employee or consultant would own all of the shares originally purchased and issued to him free of the Company's right to purchase them.

## TECHNICAL CONSULTANTS

Central to MAD's strategic plan is the integration of advanced hardware with AI, DA and Optimization software to create advanced problem-solving computers. The following noted authorities in the fields of AI, DA and optimization software have agreed to consult with the Company on an ongoing basis:

| | |
|---|---|
| David G. Luenberger, Ph.D. | Chairman; Engineering-Economic Systems; Department, Stanford University |
| John McCarthy, Ph.D. | Professor; Computer Science Department; Stanford University |
| George B. Dantzig, Ph.D. | Professor; Operation Research Department; Stanford University |
| Ronald A. Howard, Sc.D. | Professor; Department of Engineering-Economic System; Stanford University |

Drs. McCarthy and Dantzig are currently performing consulting services for the Company. Dr. Luenberger currently is not consulting for the Company although he has agreed to consult when and as requested. Dr. Howard, other than his seat on the Company's board of directors, is not currently consulting for the Company although he has agreed to consult when and as requested.

PROFESSOR DAVID G. LUENBERGER is Chairman of the Engineering-Economic Systems Department at Stanford University where he teaches graduate courses and directs research in optimization, dynamic systems, mathematical programming and economics. Professor Luenberger is an international authority in his field having authored three major textbooks. His consulting and other employment includes service to Westinghouse, the Stanford Research Institute, Systems Control, Inc., the President's Office of Science and Technology, and Congress's Office of Technology Assessment. Professor Luenberger has been increasingly involved in the conceptualization and development of computer problem solving tools.

Professor Luenberger holds B.S., M.S. and Ph.D. degrees in electrical engineering. He is a Fellow of the Institute of Electrical and Electronics Engineers.

PROFESSOR JOHN MCCARTHY is a professor in the Department of Computer Science at Stanford University. He is one of the founders of artificial intelligence, and is credited with giving artificial intelligence its name. He played a key role in founding two of the three main AI laboratories in the United States, those at Stanford and MIT. Most recently, he received the first Award for Research Excellence, at the 1985 International Joint Conference on Artificial Intelligence (IJCAI). Professor McCarthy originated the LISP programming language for computing with symbolic expressions, was one of the first to propose and design time-sharing computer systems, and was a pioneer in the use of mathematical logic in computer science.

Professor McCarthy received a B.S. in mathematics from the California Institute of Technology and a Ph.D. in mathematics from Princeton University. He has taught at Princeton, Dartmouth, M.I.T. and Stanford. He received the A.M. Turing award of the Association for Computing Machinery in 1971 for his contributions to computer science.

PROFESSOR GEORGE B. DANTZIG is a professor of Operations Research at Stanford University, and world renowned for the invention of Linear Programming.

PROFESSOR RONALD A. HOWARD is the fourth member of MAD's Scientific Advisory Board. Professor Howard is also a Director of the Company and his biographical information is located under "Management, Directors and Key Employees."

## PRINCIPAL SHAREHOLDERS

| Name and Address | Common and Common Equivalent Shares Owned | Current Ownership (%) | Pro-Forma Ownership (%) |
|---|---|---|---|
| John Nafeh<br>2950 Zanker Road<br>San Jose, CA 95134 | 4,560,683 | 30.0 | 25.0 |
| Telex Computer Products<br>6422 E. 41st Street<br>Tulsa, OK 74135 (2) | 2,675,000 | 17.6 | 14.7 |
| Universal Capital Bank Limited<br>West Bay Street<br>P.O. Box 4214<br>Nassau, Bahamas | 1,924,280 | 12.7 | 10.6 |
| Bank J. Vontobel & Co. AG<br>Bahnhofstrasse 3,<br>CH-8022 Zurich, Switzerland | 1,447,500(1) | 9.5 | 8.0 |
| Sharjah Group Trust N.V.<br>49, Park Lane<br>London W1Y 3LB England | 622,300 | 4.1 | 3.4 |
| Sal. Oppenheim Jr. & Cie.<br>Unter Sachsenhausen 4, D-500<br>Cologne, West Germany | 330,000 | 2.2 | 1.8 |

(1) Includes shares of the Company's common stock issuable upon conversion of shares of Series B Preferred Stock in accordance with the conversion provision of the Company's Restated Articles of Incorporation.

(2) See "History of Financing" for an explanation of recent sales and transfers of stock to Telex Computer Products, Inc.

## LITIGATION

### Joint Venture With ADS

In October 1984, the Company formed a joint venture with ADS called Ariel Technology, Inc. ("Ariel") to develop software and firmware products for the office which are based on artificial intelligence.

After learning on December 30 and 31, 1985, of certain actions taken by members of Ariel management, including resignation of Ariel's managerial and other employees, MAD filed suit on January 7, 1986 against Ariel, ADS and certain members of Ariel management for misappropriation of Ariel's trade secrets, breach of fiduciary duty, fraud and interference with MAD's contract rights under the joint venture. In this litigation, MAD is seeking to gain access to the Ariel technology to continue its development. A full and complete copy of the Ariel technology is now being held by an escrow agent, and MAD has obtained a court order prohibiting disclosure of the technology in escrow to ADS or the other defendants.

In the lawsuit, one defendant, ADS, had filed a claim against MAD for damages arising from MAD's alleged breach of the joint venture agreement. However, MAD has recently settled the litigation with ADS. Under the settlement, the claims of ADS against MAD are being dismissed, and ADS is withdrawing any opposition to MAD obtaining the Ariel technology now in escrow. While it is impossible to predict the outcome of any litigation matter with certainty, MAD believes that, as a result of the recent settlement with ADS, MAD should receive a copy of the Ariel technology shortly.

### Micron Technology

On June 14, 1985 Micron Technology, Inc. ("Micron") filed suit against the Company for specific performance of a supply contract and, in the alternative, damages in the amount of approximately $700,000. MAD counterclaimed against Micron, claiming defenses to the contract and claiming the contract had been modified and seeking specific performance of the contract as modified. No discovery has commenced and the parties are currently negotiating a settlement of the lawsuits. The Company does not believe this lawsuit will have a materially adverse effect on the Company.

Other

The Company is behind in its payments to a number of its vendors and other creditors. The Company is attempting to negotiate with such parties to reduce the dollar amounts due under such delinquent accounts payable. The Company has been sued by a number of creditors to collect overdue accounts, claiming an aggregate amount of approximately $764,000. The Company has negotiated settlements, at reduced amounts, of approximately $330,000 of this amount, and is in various stages of negotiation with the remaining creditors. See "Special Investment Considerations--Litigation"; "Use of Proceeds."

## SPECIAL INVESTMENT CONSIDERATIONS

Purchase of the Shares involves a substantial degree of risk and should be regarded as speculative. A purchase of Shares should be considered only by persons who can reasonably afford a loss of their entire investment. Prospective investors should carefully consider, in addition to matters set forth elsewhere in this Memorandum, the following factors relating to the business of the Company and the offering:

Limited Operating History. To date, the Company has manufactured and sold only computer hardware, and has not generated any revenues from shipment of expert systems products. The unaudited loss for the year ended December 29, 1985 was approximately $10,800,000 resulting in an accumulated deficit from operations of approximately $19 million. The Company's audit report for fiscal year 1984 was qualified as to the Company's ability to continue in business as a going concern and the Company anticipates that its 1985 audit report will carry a similar qualification. While the Company believes it will achieve profitability in early 1987 as set forth in the financial forecasts attached as Exhibit C, such forecasts are based on assumptions made by the Company with the benefit of only a limited operating history. No assurance can be given that the assumptions on which the forecasts are based will prove to be correct or that the forecast figures will be attained.

Uncertainty as to Product Development. The Company's expert systems are still under development and will depend on technology which is unproven and not fully developed. Until the products have been tested in an actual business environment, there can be no assurance that they will perform as expected or be satisfactory to potential customers.

Substantial Competition. The Company will be in competition with a number of concerns, both in the United States and abroad, that have greater resources and that have developed or may develop products which compete with the Company's products.

Market Uncertainties. The Company has made certain assumptions concerning the potential market for its products. If these assumptions prove inaccurate, the Company's revenue and cash flow forecasts may not be attained.

Dependence on Key Management Employees. The Company's development to date and in the future depends greatly on the efforts of key management and technical employees. The loss of services of any of these key contributors could have a materially adverse impact upon the progress of the business. The Company has no employment contracts covering such employees.

The Company is in the process of significantly refocusing its strategy to place greater emphasis on the development of AI workstations and software tools to aid in building expert systems for the financial services industry. While the Company intends to continue its pursuit of the marketing and development of its 80286-based product line, this effort will no longer be a primary focus of the Company's efforts and resources. When Hal Krauter, former President of the Company, was offered the restructured position of leading the 80286-based product line, without responsibility for AI products, expert systems or European operations, he offered his resignation to the Company's board of directors, which was accepted. When Mr. Krauter's resignation and the plan of reorganization were accepted by the board, George Bragg, Chairman and CEO of Telex Computer Products, Inc., a major shareholder of the Company, resigned from the Company's board of directors. Mr. Krauter has advised the Company that he is available through August 1986 to perform consulting services for the Company, if requested.

Retention and Recruitment of Other Key Personnel. Because of the specialized nature of the Company's business, especially its proposed AI and expert systems product development, it is necessary both to attract additional personnel with a wide variety of capabilities and to retain current key personnel. Competition among employers for such personnel is intense. The Company relies, and will continue to rely, on incentives, including competitive salaries, participation in stock option programs, and technical and career challenges, to attract and retain personnel with the requisite capabilities.

Proprietary Rights. No patents for the technology developed by the Company have been issued and there can be no assurance as to the breadth or degree of protection that future patents, if issued, or the copyright and trade secret laws may afford the Company res-

pecting its technology. Trade secret protection may not be available if the secrets are publicly disclosed or independently developed.

Liquidity of Investment. There is currently no public market for the Shares or for the Company's Common Stock and no such market will develop as a result of this offering. It is not known whether a trading market will ever develop. The sale of the Shares is not being registered under the Act, and the Shares may not be resold or otherwise transferred unless they are subsequently registered under the Act and qualified under applicable state laws or unless exemptions from registration and qualification are available. Accordingly, purchasers may not be able to liquidate their investment in the Shares. The certificates evidencing the Shares will contain legends referring to these restrictions on transfer.

Vendors. The Company makes extensive use of parts, facilities, and processes supplied to it by outside vendors. While it is the Company's policy to develop qualified alternate sources, this is not always feasible. Further, in other cases there could be significant delays and costs incurred to start up an alternate vendor. There can be no assurance that the Company will not suffer delays or other problems, including reduced product performance, caused by non-performance of its vendors. See "Special Investment Considerations--Litigation."

Litigation. Due to cash flow problems, the Company is significantly behind in its payments to a number of vendors of components used in the Company's now discontinued 80186-based products and suppliers of services to the Company. The Company has been sued by a number of these vendors, who are seeking to collect amounts owed to them. While the Company has settled, or is negotiating settlements of, a number of these suits, the Company's failure to settle such remaining suits could result in judgments being entered against the Company and, the Company's property being taken to satisfy such judgments. See "Litigation - Other;" Use of Proceeds."

Agreements With Philips International N.V. and Philips Information Systems, Ltd. The Company has a major OEM contract with Philips International N.V. ("Philips"), pursuant to which Philips has agreed to purchase from MAD 80286-based workstations (the "P3200") for sale under the Philips label. Philips' obligation to purchase product from MAD under the OEM agreement are limited to a rolling four month schedule of firm orders. Philips must purchase 20,000 units from MAD before Philips itself may manufacture any MAD-based products. However, recently, the Company sold its P3200 technology, which underlies the Philips OEM contract, to Philips Information Systems, Ltd. ("PIS"), a Canadian corporation wholly-owned by Philips International N.V. ("Philips") for $1.5 million. In the same transaction, the Company licensed back all such technology on a royalty

free basis. Philips is entitled, after the end of any rolling four month order period to purchase product from PIS rather than MAD. There can be no assurances that, once any rolling four month firm-order period ends, Philips will not commence purchasing P3200 from PIS rather than MAD. If this occurred, it could have a materially adverse effect on the Company, since Philips is the Company's major OEM customer.

PIS also agreed in the sale and license back transaction to aid in financing the acquisition of components for use in assembling the products to be sold to Philips under the OEM Agreement between Philips and the Company. The Company made a number of representations, warranties and covenants in the agreements relating to the above referenced sale and license back of technology. If the Company breaches any such covenants, PIS could exercise its rights as a secured creditor and succeed to all accounts receivable and inventory of the Company. See "Strategic Alliances - Philips International N.V."

Current Cash Needs and Future Financing Requirements. The Company is currently experiencing a significant need for short term financing that may not be met prior to the earliest expected closing, if any, of sales of the Series C Preferred offered hereunder. Unless such short term financing needs are timely met, the Company's financial position and prospects could be materially and adversely affected.

Management estimates that the net proceeds of this offering of the Shares, if all Shares are sold, will satisfy the Company's working capital requirements for the period from May 1986 through December 1987. The Company's failure, however, to receive in the near term the proceeds of a substantial amount of the entire $9,400,000 being sought in this offering could have a material adverse effect on the Company's business and financial condition. See "Use of Proceeds."

## ADDITIONAL INFORMATION

The Company will make available, prior to the consummation of this Offering, to each prospective investor and his representatives and advisors, if any, the opportunity to ask questions and receive answers concerning the terms and conditions of this Offering and to obtain any additional information, which the Company possesses or can obtain without unreasonable effort or expense, that is necessary to verify the accuracy of the information furnished to such prospective investor. Any such questions should be directed to: John Nafeh, Chairman of the Board, MAD Intelligent Systems, Inc., 2950 Zanker Road, San Jose, CA 95134-Telephone (408) 943-1711. No other person has been authorized to give information or to make any representations concerning this offering, and if given or made, such other information or representations must not be relied upon as having been authorized by the Company.

PEAT MARWICK

Peat, Marwick, Mitchell & Co.
Certified Public Accountants
130 Park Center Plaza
San Jose, California 95113

The Board of Directors
Mad Computer, Inc.:

We have examined the consolidated balance sheets of Mad Computer, Inc. and subsidiary as of December 31, 1984 and 1983 and the related consolidated statements of operations, stockholders' equity (deficiency) and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As shown in the consolidated financial statements, the Company has incurred substantial net losses since its inception. Continuation of the Company as a going concern is dependent upon obtaining additional financing and successful marketing of the MAD-1 computer system. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

In our opinion, subject to the effects on the consolidated financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities referred to in the preceding paragraph been known, the aforementioned consolidated financial statements present fairly the financial position of Mad Computer, Inc. and subsidiary at December 31, 1984 and 1983 and the results of their operations and the changes in their financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

February 22, 1985 except as to
note 8, which is as of March 12, 1985

MAD COMPUTER, INC. AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 1984 and 1983

| Assets | 1984 | 1983 |
|---|---|---|
| Current assets: | | |
| Cash | $ 476,313 | 2,009,858 |
| Receivables (notes 2, 6 and 12) | 1,144,138 | - |
| Inventories (notes 3 and 6) | 3,974,360 | 719,071 |
| Other current assets | 181,740 | 35,635 |
| Total current assets | 5,776,551 | 2,764,564 |
| Equipment, at cost less accumulated depreciation (notes 4 and 6) | 838,972 | 339,530 |
| Investment in joint venture (note 8) | 166,854 | - |
| Other assets | - | 3,778 |
| | $ 6,782,377 | 3,107,872 |
| **Liabilities and Stockholders' Equity (Deficiency)** | | |
| Current liabilities: | | |
| Notes payable (notes 5 and 6) | $ 3,603,043 | 13,272 |
| Accounts payable (note 5) | 3,558,379 | 540,923 |
| Accrued expenses | 356,430 | 162,386 |
| Total current liabilities | 7,517,852 | 716,581 |
| Long-term debt (note 6) | 12,999 | - |
| Unearned income (note 10) | 600,000 | 1,000,000 |
| Stockholders' equity (deficiency) (note 9): | | |
| Preferred stock | 5,247,816 | 2,592,270 |
| Common stock | 1,615,000 | 1,615,000 |
| Accumulated deficit | (8,171,290) | (2,775,979) |
| | (1,308,474) | 1,431,291 |
| Notes receivable from sale of common stock | (40,000) | (40,000) |
| Net stockholders' equity (deficiency) | (1,348,474) | 1,391,291 |
| Commitments (notes 7 and 8) | | |
| | $ 6,782,377 | 3,107,872 |

See accompanying notes to consolidated financial statements.

MAD COMPUTER, INC. AND SUBSIDIARY

Consolidated Statements of Operations

Years ended December 31, 1984 and 1983

| | 1984 | 1983 |
|---|---|---|
| Revenues (note 12) | $ 8,979,857 | 212,341 |
| Cost of sales | 8,735,484 | - |
| Gross profit | 244,373 | 212,341 |
| Operating expenses: | | |
| Research and development | 1,372,623 | 856,832 |
| Selling, general and administrative expenses | 4,667,061 | 1,007,215 |
| Loss from operations | (5,795,311) | (1,651,706) |
| Other income (expense): | | |
| Amortization of unearned income (note 10) | 400,000 | - |
| Prototype design costs funded by related company (note 5) | - | (1,010,030) |
| Loss before income taxes | (5,395,311) | (2,661,736) |
| Income taxes (note 11) | - | 114,000 |
| Net loss | $(5,395,311) | (2,775,736) |

See accompanying notes to consolidated financial statements.

MAD COMPUTER, INC. AND SUBSIDIARY

Consolidated Statements of Stockholders' Equity (Deficiency)

Years ended December 31, 1984 and 1983

| | Common stock | | Preferred stock | | Accumulated deficit | Receivable from sale of common stock | Net stockholders' equity (deficiency) |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | |
| Balances at December 31, 1982 | 4,100,000 | $ 410,000 | - | $ - | (243) | (409,000) | 757 |
| Shares issued and settlement of receivable as part of sale of technology agreement (note 5) | 1,900,000 | 665,000 | - | - | - | 409,000 | 1,074,000 |
| Shares and warrants issued | 80,000 | 540,000 | 2,053,200 | 2,592,270 | - | (40,000) | 3,092,270 |
| Net loss | - | - | - | - | (2,775,736) | - | (2,775,736) |
| Balances at December 31, 1983 | 6,080,000 | 1,615,000 | 2,053,200 | 2,592,270 | (2,775,979) | (40,000) | 1,391,291 |
| Shares issued | - | - | 783,484 | 2,655,546 | - | - | 2,655,546 |
| Net loss | - | - | - | - | (5,395,311) | - | (5,395,311) |
| Balances at December 31, 1984 | 6,080,000 | $ 1,615,000 | 2,836,684 | $ 5,247,816 | (8,171,290) | (40,000) | (1,348,474) |

See accompanying notes to consolidated financial statements.

MAD COMPUTER, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Financial Position

Years ended December 31, 1984 and 1983

| | 1984 | 1983 |
|---|---|---|
| Uses of working capital: | | |
| Net loss | $ 5,395,311 | 2,775,736 |
| Items not (using) providing working capital: | | |
| Depreciation | (168,072) | (76,632) |
| Amortization of unearned income | 400,000 | - |
| Working capital used by operations | 5,627,239 | 2,699,104 |
| Additions to equipment | 667,514 | 416,162 |
| Investment in joint venture | 166,854 | - |
| Increase in other assets | - | 3,748 |
| Increase in working capital | - | 2,047,256 |
| | $ 6,461,607 | 5,166,270 |
| Sources of working capital: | | |
| Decrease in other assets | 3,778 | - |
| Prepaid royalties received on licensing agreement | - | 1,000,000 |
| Increase in long-term debt | 12,999 | - |
| Common stock and warrants issued for cash | - | 500,000 |
| Common stock issued in exchange for technology | - | 665,000 |
| Sale of preferred stock | 2,655,546 | 2,592,270 |
| Settlement of receivable as part of sale of technology | - | 409,000 |
| Decrease in working capital | 3,789,284 | - |
| | $ 6,461,607 | 5,166,270 |
| Changes in components of working capital: | | |
| Increase (decrease) in current assets: | | |
| Cash | (1,533,545) | 2,009,131 |
| Receivables | 1,144,138 | - |
| Inventories | 3,255,289 | 719,071 |
| Other current assets | 146,105 | 35,635 |
| | 3,011,987 | 2,763,837 |
| Increase in current liabilities: | | |
| Notes payable | 3,589,771 | 13,272 |
| Accounts payable | 3,017,456 | 540,923 |
| Accrued expenses | 194,044 | 162,386 |
| | 6,801,271 | 716,581 |
| Increase (decrease) in working capital | $(3,789,284) | 2,047,256 |

See accompanying notes to consolidated financial statements.

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

Years ended December 31, 1984 and 1983

(1) The Company and Summary of Significant Accounting Policies

(a) The Company

Mad Computer, Inc. ("the Company") was incorporated on February 8, 1982 and is engaged in development, production and marketing of the MAD-1 computer. Prior to 1984, the Company was a development stage enterprise as defined by Statement of Financial Accounting Standards No. 7. In November 1983, the Company formed a wholly owned subsidiary in Germany to market the MAD-1 computer. The accounts of the Company also include its 50% undivided equity interest in a newly formed joint venture which is accounted for on the equity method. Intercompany balances and transactions are eliminated in consolidation.

(b) Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market (net realizable value).

(c) Depreciation

Depreciation is provided on the straight-line method over the estimated useful lives (three to five years) of the respective assets.

(d) Research and Development

Expenditures for research and development are expensed as incurred.

(e) Revenue Recognition

Revenues are recognized upon shipment of product. Royalty income is recognized on the accrual basis as earned.

(f) Income Taxes

Investment tax and research and experimentation tax credits are recorded as a reduction of Federal income taxes in the year realized.

(g) Foreign Currency Translation

Foreign currency translation and transaction gains and losses are included in current operating results and are immaterial.

(2) Receivables

Receivables are summarized as follows:

| | 1984 | 1983 |
|---|---|---|
| Trade receivables (see note 12) | $ 1,224,283 | 66,661 |
| Less allowance for doubtful receivables | (80,145) | (66,661) |
| | $ 1,144,138 | - |

(Continued)

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(3) Inventories

Inventories are summarized as follows:

| | 1984 | 1983 |
|---|---|---|
| Raw materials | $ 2,594,065 | 555,234 |
| Work-in-process and finished goods | 1,380,295 | 163,837 |
| | $ 3,974,360 | 719,071 |

(4) Equipment

Equipment is summarized as follows:

| | 1984 | 1983 |
|---|---|---|
| Equipment, machinery and fixtures | $ 827,905 | 133,397 |
| Tooling | 255,771 | 282,765 |
| | 1,083,676 | 416,162 |
| Less accumulated depreciation | 244,704 | 76,632 |
| | $ 838,972 | 339,530 |

(5) Related Parties

Prior to 1984, the Company's research and development expenditures and personnel support were funded by a related company. Mad Computer, Inc. and the related company are effectively owned by the same stockholders. The technology developed as a result of the related company's expenditures was sold in 1983 to the sole stockholder of Mad Computer, Inc. for a purchase price of $1,074,000 determined as follows:

| | |
|---|---|
| Direct expenditures funded by related company | $ 764,000 |
| Labor costs allocated by related company | 104,000 |
| Margin to the related company | 206,000 |
| | $ 1,074,000 |

Labor costs were allocated based on management's assessment of the time devoted to the development of the MAD-1 computer.

The sole stockholder of Mad Computer, Inc. subsequently sold the above technology to the Company for:

| | |
|---|---|
| 1,900,000 shares of common stock | $ 665,000 |
| Settlement of the balance owed on shares issued at incorporation | 409,000 |
| | $ 1,074,000 |

(Continued)

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(5) Related Parties, Continued

Included in the above purchase price are prototype design costs of $1,010,030 incurred by the related company. Accordingly, these costs have been expensed by Mad Computer, Inc.

At December 31, 1984, the Company owes the related company $122,850 which is included in accounts payable. In addition, the Company has a $500,000 note payable to its major stockholder bearing interest at a rate of 14% annually.

(6) Debt

A summary of debt follows:

| | 1984 | 1983 |
|---|---|---|
| Borrowings under a line of credit expiring April 30, 1985, as discussed below | $ 2,000,000 | - |
| 14% demand notes payable | 1,103,043 | 13,272 |
| Non-interest bearing demand obligation | 500,000 | - |
| Obligations under capital leases | 12,999 | - |
| | 3,616,042 | 13,272 |
| Less current portion | 3,603,043 | 13,272 |
| Long-term debt, excluding current portion | $ 12,999 | - |

In 1984, the Company entered into an agreement with a venture capital group which provides for borrowings under a line of credit bearing interest at 16%. The maximum borrowings under the agreement is $2,000,000. Borrowings under the line are secured by the Company's assets.

During 1984, the Company was advanced $500,000 from a placement agent representing funds received in connection with a proposed sale of the Company's Series C preferred stock. As of December 31, 1984 no shares of the Series C preferred stock had yet been authorized or issued but the Company's management expects issuance of these shares to take place later in 1985. The advance does not bear interest and is classified above as a demand obligation.

(Continued)

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(7) Lease Commitments

The Company leases its San Jose, California facility under a noncancellable operating lease expiring in August 1989. The Company also leases a facility in Germany under a noncancellable operating lease expiring in 1989. The Company is responsible for real estate taxes, insurance and maintenance expenses on both leases. Total rental expense for operating leases approximated $223,190 and $100,000 in 1984 and 1983, respectively.

Minimum future lease payments under all noncancellable operating leases are as follows:

| Years ending | |
|---|---|
| 1985 | $ 665,665 |
| 1986 | 937,590 |
| 1987 | 937,590 |
| 1988 | 937,590 |
| 1989 | 593,595 |
| Thereafter | - |
| | $ 4,072,030 |

(8) Joint Venture

In September 1984, the Company entered into a joint venture with another company for the development, manufacture and marketing of computer software and hardware products based on artificial intelligence. Each company has agreed to invest $300,000 in the joint venture for a 50% ownership interest As of December 31, 1984, the Company had invested approximately $167,000. The balance of the capital contribution was made subsequent to December 31, 1984. The terms of the joint venture agreement were amended on March 12, 1985 under which the Company is further obligated to lend up to $500,000 for general working capital purposes. The advances are to be made at $50,000 per month beginning in April 1985. Such loans are due and payable upon liquidation of the joint venture, or earlier if both the joint venture partners agree. The joint venture's results of operations in 1984 were not significant.

(Continued)

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(9) Capital Stock

Capital stock is summarized as follows:

| | December 31, 1984 | December 31, 1983 |
|---|---|---|
| Series A noncumulative preferred stock; authorized 2,500,000 shares; issued and outstanding 2,053,200 shares in 1984 and 1983 | $ 2,592,270 | 2,592,270 |
| Series B noncumulative preferred stock; authorized 2,080,000 shares; issued and outstanding 783,484 shares in 1984 and none in 1983 | $ 2,655,546 | - |
| Common stock; no par value; authorized 20,000,000 shares; issued and outstanding 6,080,000 shares in 1984 and 1983 | $ 1,615,000 | 1,615,000 |

The Company has also issued warrants to a major customer to purchase 2,000,000 common shares at $0.50 per share on or before November 1988. The Company received $500,000 in cash in consideration for the warrants.

An aggregate of 7,500,000 shares of designated and undesignated no par value preferred stock is authorized for issuance.

The rights of the Series A and B preferred stockholders are as follows:

(a) Holders are entitled to a noncumulative dividend of $.135 and $.375 per share, respectively, before any dividend is paid to common stockholders.

(b) In the event of liquidation, holders are entitled to a distribution of $1.35 and $3.75 per share, respectively. Any surplus remaining after distribution to the preferred stockholders shall be distributed solely to the common stockholders.

(c) The preferred stock is convertible, on a one-for-one basis, into common stock, at the option of the holder or upon the closing of an underwritten public offering of the Company's common stock.

The Company is authorized to issue 1.2 million common shares under the 1983 incentive stock option plan which provides for grant of stock options to employees at prices not less than fair value at the date of grant. Options have five-year terms and are exercisable commencing one year from the date of grant in cumulative and annual installments of 25%.

(Continued)

MAD COMPUTER, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

(9) Capital Stock, Continued

A summary of 1984 transactions under the stock option plan follows:

| | Shares available for grant | Options outstanding | | |
|---|---|---|---|---|
| | | Shares | Price per Share | Amount |
| Balances at December 31, 1983 | 700,000 | - | $ - | $ - |
| Additional shares reserved | 500,000 | - | - | - |
| Granted | (1,258,000) | 1,258,000 | 0.50-0.75 | 719,750 |
| Cancelled | 486,500 | (486,500) | 0.50 | (243,250) |
| Balances at December 31, 1984 | 428,500 | 771,500 | $ 0.50-0.75 | $ 476,500 |
| Exercisable at December 31, 1984 | | 102,625 | $ 0.50 | |

(10) Unearned Income

The Company has a four-year license agreement with a computer communications company to manufacture, use and sell hardware and software developed by Mad Computer, Inc. In 1983, the Company received a prepaid royalty of $1,000,000 upon execution of the license agreement and is recognizing this amount as royalty income over two years. In addition, the Company is to receive royalties based on units to be manufactured by the Company and sold by the licensee. The Company recognized $400,000 in royalty income during 1984.

(11) Income Taxes

As of December 31, 1984 the Company has a net operating loss carryforward approximating $4,950,000 and $6,300,000 for Federal income tax and financial statement purposes, respectively. The difference arises principally because of certain prepaid royalties recognized for tax purposes and certain preoperating costs expensed for financial statement purposes but not for tax purposes. The Company also has investment and research and development tax credit carryforwards approximating $80,000 and $185,000, respectively. These carryforwards will expire in 1998 and 1999. The $114,000 tax expense in 1983 represents deferred minimum tax provided in connection with research and development expenditures deducted during 1983.

(12) Major Customers

In 1984, two customers accounted for approximately 85% of the Company's revenues. Related accounts receivable from these customers at December 31, 1984 approximated $902,000.

EXHIBIT B

DECEMBER 29, 1985

UNAUDITED FINANCIAL STATEMENTS

SUMMARY STATEMENT OF OPERATIONS, CONSOLIDATED ($-000's)

| | Unaudited Year ended 12/29/85 |
|---|---|
| REVENUE | $ 5,159 |
| COST | 8,247 |
| GROSS MARGIN | (3,088) |
| EXPENSES | 7,666 |
| LOSS | $ (10,754)(1) |

SUMMARY BALANCE SHEET, CONSOLIDATED ($000's)

| | Unaudited Year ended 12/29/85 |
|---|---|
| Assets: | |
| Current | $ 1,055 |
| Other | 1,353 |
| Total | $ 2,408 |
| Liabilities: | |
| Current | 3,908 |
| Other | 300 |
| Total | $ 4,208 |
| Equity | (1,800) |
| Total Liabilities & Equity | $ 2,408 |

(1) The loss of $10.8 million for the 1985 fiscal year is attributable to the following factors:
- (a) Write off of all assets associated with the Company's 186 product line, including inventory, tooling, test equipment, etc. -$3.5 M;
- (b) Factory underutilization prior to volume production of the 286 product line - $1.2m;
- (c) Engineering development costs of 286 product line - $1.8m;
- (d) Manufacturing expenses associated with the commencement of volume 286 production - $.6m;
- (e) Hardware development expense for 386 product line - $.3m;
- (f) Expert systems planning and development costs - $.6m.

EXHIBIT C

# THREE-YEAR PRO FORMA

## FINANCIAL PROJECTIONS WITH ASSUMPTIONS

THE FOLLOWING PROJECTIONS HAVE BEEN PREPARED BY THE COMPANY ON THE BASIS OF CERTAIN ASSUMPTIONS WHICH IT BELIEVES TO BE REASONABLE. HOWEVER, NO ASSURANCE CAN BE GIVEN AS TO THEIR ULTIMATE ACCURACY SINCE THEY ARE DEPENDENT IN LARGE PART UPON FACTORS OVER WHICH THE COMPANY HAS NO CONTROL. ACCORDINGLY, THEY SHOULD BE VIEWED MERELY AS AN ORDERLY PRESENTATION OF RESULTS THAT MIGHT BE ACHIEVED SHOULD ALL OF THE ASSUMPTIONS BE REALIZED. THE PROJECTIONS ARE NOT REPRESENTED AS SPECIFIC RESULTS WHICH WILL BE ACHIEVED.

MAD INTELLIGENT SYSTEMS, INC.
PROJECTED STATEMENT OF OPERATIONS
(CONSOLIDATED IN $000'S)

| | 1986 | | | | | 1987 | | | | | 1988 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1Q | 2Q | 3Q | 4Q | TOTAL | 1Q | 2Q | 3Q | 4Q | TOTAL | TOTAL |
| REVENUE | | | | | | | | | | | |
| HARDWARE | | | | | | | | | | | |
| GENERAL PURPOSE | $ 1,050 | $ 4,590 | $4,905 | $6,655 | $17,200 | $ 6,500 | $6,500 | $4,000 | $ 4,000 | $21,000 | $26,000 |
| APPLICATION SPECIFIC | -- | -- | -- | -- | -- | -- | -- | 3,000 | 10,000 | 13,000 | 33,000 |
| EXPERT SYSTEMS | -- | -- | -- | -- | -- | -- | -- | 250 | 500 | 750 | 5,000 |
| ROYALTY/FUNDED DEV. | 26 | 100 | 60 | 60 | 246 | 250 | 250 | 250 | 250 | 1,000 | 2,000 |
| TOTAL | 1,076 | 4,690 | 4,965 | 6,715 | 17,446 | 6,750 | 6,750 | 7,500 | 14,750 | 35,750 | 66,000 |
| COST OF SALES | | | | | | | | | | | |
| HARDWARE | | | | | | | | | | | |
| GENERAL PURPOSE | 1,515 | 4,511 | 4,553 | 5,724 | 16,303 | 5,200 | 5,200 | 3,200 | 3,200 | 16,800 | 19,500 |
| APPLICATION SPECIFIC | -- | -- | -- | -- | -- | -- | -- | 1,800 | 6,000 | 7,800 | 19,800 |
| EXPERT SYSTEMS | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| ROYALTY PAID | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| TOTAL | 1,515 | 4,511 | 4,553 | 5,724 | 16,303 | 5,200 | 5,200 | 5,000 | 9,200 | 24,600 | 39,300 |
| GROSS MARGIN | (439) | 179 | 412 | 991 | 1,143 | 1,550 | 1,550 | 2,500 | 5,550 | 11,150 | 26,700 |
| EXPENSES | | | | | | | | | | | |
| MARKETING | 351 | 472 | 381 | 480 | 1,684 | 600 | 600 | 600 | 700 | 2,500 | 4,500 |
| R & D | | | | | | | | | | | |
| ENGINEERING | 236 | 233 | 165 | 165 | 799 | 200 | 200 | 200 | 200 | 800 | 1,200 |
| EXPERT SYSTEMS | 76 | 277 | 322 | 438 | 1,113 | 450 | 450 | 450 | 450 | 1,800 | 3,000 |
| ADVANCED AI DEV. | 1 | 100 | 400 | 400 | 901 | 400 | 400 | 400 | 400 | 1,600 | 2,300 |
| TOTAL | 313 | 610 | 887 | 1,003 | 2,813 | 1,050 | 1,050 | 1,050 | 1,050 | 4,200 | 6,500 |
| GENERAL | 540 | 448 | 400 | 390 | 1,778 | 450 | 450 | 450 | 450 | 1,800 | 3,000 |
| TOTAL | 1,204 | 1,530 | 1,668 | 1,873 | 6,275 | 2,100 | 2,100 | 2,100 | 2,200 | 8,500 | 14,000 |
| PROFIT BEFORE INT/TAXES | (1,643) | (1,351) | (1,256) | ( 882) | (5,132) | ( 550) | ( 550) | 400 | 3,350 | 2,650 | 12,700 |
| NET INTEREST | ( 56) | ( 33) | ( 33) | ( 33) | ( 155) | ( 33) | ( 33) | ( 33) | ( 33) | ( 132) | -- |
| PROFIT BEFORE TAX | (1,699) | (1,384) | (1,289) | ( 915) | (5,287) | ( 583) | ( 583) | 367 | 3,317 | 2,518 | 12,700 |
| TAX PROVISION | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- | 950 |
| PROFIT AFTER TAX | (1,699) | (1,384) | (1,289 | ( 915) | (5,287) | ( 583) | ( 583) | 367 | 3,317 | 2,518 | 11,750 |

**MAD INTELLIGENT SYSTEMS**
**PROFORMA BALANCE SHEET FOR EOY 1985 THROUGH 1988**

| | 12/85 | 3/86 | 6/86 | 9/86 | 12/86 | 3/87 | 6/87 | 9/87 | 12/87 | 12/88 |
|---|---|---|---|---|---|---|---|---|---|---|
| CASH | $ 460 | $ 0 | $ 275 | $ 4,975 | $ 3,225 | $ 2,375 | $ 1,725 | $ 1,975 | $24,825 | $31,900 |
| A/R | $ 205 | $ 200 | $ 1,800 | $ 1,700 | $ 2,400 | $ 2,400 | $ 2,100 | $ 2,200 | $ 2,300 | $ 6,200 |
| INVENTORY | $ 215 | $ 450 | $ 500 | $ 1,600 | $ 1,800 | $ 2,000 | $ 2,200 | $ 2,100 | $ 2,100 | $ 5,500 |
| PREPAID EXP | $ 170 | $ 150 | $ 200 | $ 300 | $ 400 | $ 500 | $ 600 | $ 700 | $ 900 | $ 1,800 |
| FIXED ASSETS | $ 850 | $ 800 | $ 900 | $ 1,100 | $ 1,350 | $ 1,500 | $ 1,650 | $ 1,800 | $ 1,950 | $ 3,200 |
| NOTES RECEIVABLE | $ 500 | $ 400 | $ 400 | $ 400 | $ 400 | $ 400 | $ 400 | $ 400 | $ 400 | $ 400 |
| TOTAL ASSETS | $ 2,400 | $ 2,000 | $ 4,075 | $10,075 | $ 9,575 | $ 9,175 | $ 8,675 | $ 9,175 | $32,475 | $49,000 |
| ACCOUNTS PAYABLE | $ 2,660 | $ 2,700 | $ 3,300 | $ 3,600 | $ 3,900 | $ 4,000 | $ 4,100 | $ 4,100 | $ 4,100 | $ 8,000 |
| ACCRUED EXPENSES | $ 960 | $ 1,100 | $ 1,500 | $ 1,500 | $ 1,500 | $ 1,600 | $ 1,600 | $ 1,700 | $ 1,700 | $ 2,500 |
| NOTES PAYABLE | $ 170 | $ 800 | $ 800 | $ 800 | $ 800 | $ 800 | $ 800 | $ 800 | $ 800 | $ 800 |
| OTHER | $ 410 | $ 375 | $ 375 | $ 375 | $ 375 | $ 375 | $ 375 | $ 375 | $ 375 | $ 400 |
| TOTAL LIABILITIES | $ 4,200 | $ 4,975 | $ 5,975 | $ 6,275 | $ 6,575 | $ 6,775 | $ 6875 | $ 6,975 | $ 6,975 | $11,700 |
| NET EQUITY | $ (1,800) | $ (2,975) | $ (1,900) | 3,800 | $ 3,000 | $ 2,400 | $ 1,800 | $ 2,200 | $25,500 | 37,300 |
| LIABILITIES PLUS EQUITY | $ 2,400 | $ 2,000 | $ 4,075 | $10,075 | $ 9,575 | $ 9,175 | $ 8,675 | $ 9,175 | $32,475 | $49,000 |

MAD INTELLIGENT SYSTEMS, INC.

SUMMARY OF FINANCIAL ASSUMPTIONS

NOTES TO PROJECTED 1986-1988 STATEMENT OF OPERATIONS

Revenue in 1986 is comprised of primarily 286 IBM AT compatible workstations with $13.0 million designated as Philips product. Revenue of 286 product increases slightly in 1987 and then begins to decline in 1988 as the higher margin 386 product deliveries accelerate in 1988. Additionally, the high margin expert systems software products increase over time beginning in Q3 1987.

Cost of Sales in 1986 is high due to the start up of the new 286 manufacturing line. The resulting margin achieved on the 286 product and the higher margin 386 product is introduced. In 1988, the margin increases to 40% as the 386 volume increases and the software sales of expert systems begin to significantly contribute to the bottom line.

Expenses as a percentage of revenues for the three years are as follows:

| Function | '86 | '87 | '88 |
|---|---|---|---|
| Marketing/Sales | 10% | 7% | 7% |
| Engineeing | 5 | 2 | 2 |
| Expert Systems | 6 | 5 | 5 |
| Advanced Development | 5 | 4 | 3 |
| General & Administrative | 10 | 5 | 5 |

These expenses reflect averages that are standard for businesses of an OEM nature, with similarly engineered products.

Profit after taxes - The results for the full year will reflect a loss. The Company becomes profitable in the third quarter of 1987. The Company expects profits of 7% and 18% for 1987 and 1988, respectively. These percentages are typical of a company in the start-up manufacturing phase for high tech proprietary products.

## CASH FLOW 1986-1988

Externally financed cash requirements of MAD are estimated by management to be as follows:

| | | |
|---|---|---|
| Fiscal 1986 | Q2 | 2.4 million |
| | Q3 | 7.0 million |
| | Q4 | -0- |
| Fiscal 1987 | | $-0- |
| Fiscal 1988 | | $-0- |

There can be no assurance, however, that any such proposed financing will be consummated by the Company. Failure to close such proposed financings and obtain the proceeds from them in a timely fashion could have a materially adverse effect on the operations and prospects of the Company. See "Risk Factors and Certain Considerations -- Current Cash Needs and Future Financing Requirements."

## PRO FORMA BALANCE SHEET ASSUMPTIONS FOR FISCAL YEARS 1986-1988

All assumptions regarding days sales outstanding are 30 days, inventory turns using just-in-time delivery average 9 turns per year and accounts payable are maintained at industry standards.